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C O N F I D E N T I A L SECTION 01 OF 04 TAIPEI 004938

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SUBJECT: CROSS-STRAIT BANKING - RESTRICTING COMPETITIVENESS
AND REFORM

REF: TAIPEI 4851

Classified By: AIT Director Douglas H. Paal, Reason 1.4 d

Summary

1. (C) The Taiwan government continues to maintain restrictions that prevent Taiwan banks from expanding their operations in the PRC and forbid PRC banks from establishing any presence in Taiwan. Taiwan's Financial Supervisory Commission (FSC) stands ready to implement liberalization measures, but has not yet been authorized to do so. Taiwan banks are eager to follow their customers, the Taiwan businesses that have invested billions in the PRC. Their competitors are moving in to provide the services that Taiwan banks cannot. Fubon Bank hopes to use a bank it acquired in Hong Kong to expand into the PRC market but also faces Taiwan restrictions. Chinatrust, on the other hand, has decided to focus on international expansion in other markets. Taiwan's cross-strait banking restrictions not only hold back Taiwan banks' ability to grow, they also impede the Taiwan government's own financial sector reform goals and economic growth strategy. End summary.

Restrictions Hinder Expansion in Both Directions

2. (U) The Taiwan government continues to maintain restrictions that prevent Taiwan banks from expanding their operations in the PRC. Taiwan banks are not permitted by Taiwan regulations to open bank branches that can engage in the full range of banking services, such as issuing loans and accepting deposits. Taiwan law also prohibits Taiwan investors from investing in Chinese banks. Taiwan banks are only permitted to open representative offices in the PRC, which can conduct research, act as a liaison for the bank, and perform some marketing functions but cannot offer banking services. Taiwan banks and foreign banks in Taiwan are also permitted to establish offshore banking units (OBU) in Taiwan. OBUs are able to conduct business with PRC financial institutions.

3. (U) Similarly, Taiwan does not permit PRC banks to establish offices in Taiwan, including representative offices. At least four Chinese banks have expressed interest in setting up representative offices in Taiwan -- China Merchants Bank, Fujian Development Bank, Industrial and Commercial Bank of China, and Shanghai Pudong Development Bank. Taiwan's Financial Supervisory Commission (FSC) has indicated that there is no regulation prohibiting PRC banks from establishing a representative office in Taiwan, but has not yet been authorized to establish a mechanism to approve PRC banks. Some in Taiwan fear the potential for the PRC to use its banks to manipulate Taiwan's financial system. However, many Taiwan banks have encouraged the government to permit PRC banks to open representative offices, largely out of the hope that the PRC would in turn allow Taiwan representative offices to upgrade to bank branches.

4. (C) Gary Tseng, Director General of the Banking Bureau of Taiwan's Financial Supervisory Commission (FSC), told AIT/T that the FSC is well prepared to implement the relaxation of cross-strait banking restrictions. They have already drafted rules, criteria and forms for proposed measures, including approval of Taiwan bank branches in the PRC. They expect these topics to be discussed at next year's planned Economic Development Advisory Conference (EDAC), which will gather officials, academics and businessmen to make economic recommendations for the government. Some officials and industry observers have argued that before allowing Taiwan banks to establish branches in the PRC, the Taiwan government must first sign some form of financial supervisory agreement with the PRC. Tseng, however, denied that such an agreement would be a

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prerequisite. Currently, he said, the real obstacle in Taiwan to cross-strait banking liberalization is lack of political will.

15. (C) In addition, the PRC may not be eager to permit Taiwan banks to open branches in the Mainland, at least until Taiwan has allowed PRC banks to open representative offices. Unlike manufacturing where PRC authorities have actively sought Taiwan investment despite Taiwan restrictions on PRC investment in Taiwan, the PRC may have less reason to encourage Taiwan banks to set up shop in the PRC. Taiwan banks do not have sufficient capital to help improve the balance sheets of the PRC's major banks. Other foreign banks with more resources have already begun to invest in the PRC. As a result, Mainland bankers may be losing interest in closer ties with Taiwan. Andrea Lee, Deputy Director General for International Affairs at Taiwan's Financial Supervisory Commission told AIT/T that PRC participation at the annual Cross-Strait Financial Forum, which was held in Taipei on November 8, has dropped dramatically from previous years. At the first forum 11 years ago, the PRC delegation had more than 80 members. This year there were fewer than 30 PRC participants.

Taiwan Banks Eager to Follow Customers

16. (U) Currently, eight Taiwan banks have representative offices in the PRC, namely Changhwa Commercial Bank, China Trust Commercial Bank, Cooperative Bank of Taiwan, First Commercial Bank, International Commercial Bank of China, Huanan Commercial Bank, Land Bank of Taiwan, and United World Chinese Commercial Bank. As of August 2005, there were 70 offshore banking units in Taiwan operated by 41 domestic banks and 29 foreign banks. The combined assets of offshore banking units equaled USD 64 billion.

17. (U) Taiwan banks are eager to offer banking services in the PRC not only because of its rapid growth but more importantly because they want to follow their customers, the Taiwan businesses that have invested so heavily in the PRC. Many estimates of cumulative Taiwan investment in the PRC top USD 100 billion. The PRC is now the destination for nearly 70 percent of Taiwan's outward investment. More than 65 percent of firms listed on the Taiwan stock exchange have invested in the PRC. Some estimate that over two million Taiwan investors and their families now live in the PRC.

18. (C) The competition is ready in the PRC to provide the services that Taiwan banks are not permitted to provide. Chinatrust Commercial Bank Managing Director for International Corporate Banking William Hon told AIT/T that other foreign banks in the PRC such as HSBC and the Development Bank of Singapore (DBS) have put together teams of Taiwan employees to specifically target Taiwan businessmen in the PRC. In fact, Hon said that he put together such a team when he worked for DBS. Taiwan banks are losing business from existing customers because they cannot effectively provide services in the PRC.

Fubon - Using Hong Kong to Bridge the Strait

19. (U) One Taiwan bank, Fubon Bank, has purchased a Hong Kong bank motivated in part by plans to use the Closer Economic Partnership Arrangement (CEPA) to penetrate the PRC banking market. In February 2004, Fubon bought a 55-percent stake in Hong Kong's International Bank of Asia (IBA) from Arab Banking Corporation. Two months later it bought another 20 percent of the bank's shares from China Everbright Holdings, a PRC state-owned enterprise. The remaining 25 percent of the bank's shares are held by the public. In April 2005, IBA changed its name to Fubon Bank (Hong Kong) Ltd. and opened a representative office in Dongguan, Guangzhou, later in the year.

110. (C) Fubon's Chairman Daniel Tsai told AIT that the bank's main purpose in acquiring IBA was to internationalize the bank. However, a subsequent conversation with Fubon Chief Financial Officer Victor Kung made it clear that gaining a platform for penetrating the PRC market was also an important part of the firm's calculations. With CEPA, Hong Kong banks can open branch offices in the PRC under less stringent requirements than foreign banks. However, Fubon is not yet able to take advantage of this mechanism. When Taiwan's Banking Bureau approved Fubon's acquisition of the International Bank of Asia, it required Fubon to seek permission from Taiwan authorities before opening a branch in the PRC as one of the terms of approval. Fubon must also seek permission before the Hong Kong bank can purchase a majority stake in a PRC bank.

111. (C) However, Fubon's Kung told econoff that approval of the IBA purchase did not place any restrictions on the Hong Kong bank's ability to purchase a minority stake in a PRC bank. Kung said that Fubon was looking for an appropriate investment target in the PRC. He commented that the PRC's national banks were too large for Fubon to buy a meaningful stake that would give it some degree of control. Instead Fubon would target what Kung called the city commercial

banks or third-tier banks where the Taiwan firm could more effectively add value to PRC operations. Kung said that Fubon might consider informing Taiwan authorities of its intent to purchase a minority stake through the Hong Kong bank instead of actually seeking permission. (Comment: This would be highly risky for one of Taiwan's largest financial groups and an unlikely strategy, particularly for Fubon, whose Chairman has told AIT that he is focused on the need for good corporate governance. End comment.)

12. (C) Kung also noted that other Taiwan banks were unlikely to follow their lead and use a Hong Kong bank to expand operations in the Mainland because there were no other suitable investment targets for Taiwan banks in the Hong Kong banking sector. Fubon's purchase of IBA was a USD 300-400 million investment. Fubon's total market capitalization is about USD 8 billion, making it one of Taiwan's two largest financial groups. IBA was one of the smallest banks in Hong Kong when Fubon purchased it. According to Kung, the next smallest possible purchase target in Hong Kong for a Taiwan bank has a market capitalization of more than USD 1 billion. Such a large bank would be a difficult target for Taiwan's financial institutions.

13. (U) Bank SinoPac may be pursuing a similar strategy through its U.S. subsidiary. Bank SinoPac purchased Far East National Bank (FENB) in California in 1997. FENB has a representative office in Beijing. FENB's website describes one of its roles as supporting the SinoPac Holdings group in China with its representative office and a strategic relationship with First Sino Bank in Shanghai.

Chinatrust - Turning Elsewhere

14. (C) Chinatrust, on the other hand, is pursuing expansion in other foreign markets. Chinatrust's Hon told AIT/T that his firm believes the Taiwan market is overcrowded and that the bank's best opportunity for growth is overseas. It is trying to expand operations in the United States and Southeast Asia in particular. In different markets, it is concentrating on different segments of banking. In the Philippines, for example, it is focused on consumer banking, but in Indonesia it focuses on investment banking. Chinatrust is eager to expand in to the PRC, but Hon called Fubon's strategy risky. He pointed out that before Fubon bought IBA, it was the second smallest bank in Hong Kong and not profitable.

Comment - Holding Back Banks and Financial Reform

15. (C) Policies that keep Taiwan banks from offering services in the PRC not only hold back Taiwan banks' ability to grow but also impede government banking sector reform plans. One of the Taiwan government's goals is to turn Taiwan into a major financial center for Asia. Taiwan banks cannot become major players in the region if they can't compete in the region's most rapidly growing market, one where they have a ready-made customer base and a cultural advantage. Restrictions also make Taiwan banks less attractive to foreign buyers, obstructing the government's goal of selling one of the state-owned banks to a foreign investor. Under its WTO accession commitments, the PRC will give foreign banks national treatment next year. As Fubon's Kung put it, the window for Taiwan banks to get into the PRC market early is getting smaller and smaller, but it will never be too late. Concerns about effective supervision of branches in the PRC are legitimate but not insurmountable. When there is political will to maximize the competitiveness of Taiwan banks in the Asia financial market, Taiwan will find a mechanism that allows its banks to operate in the PRC. End comment.

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